Overview of Stock Option Grants in China

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This memorandum is an overview of the legal and strategic issues related to granting options in China, including understanding Chinese cultural views of employment and compensation, structuring option grants to comply with applicable Chinese exchange control and securities restrictions and the tax consequences of options to the optionee. The memorandum is applicable whether the company granting the options is a U.S. or Cayman Island entity.

Implementing an equity-based compensation program for employees resident in foreign jurisdictions is a challenging, and sometimes costly, undertaking. Because the use of options and other equity-based compensation has only recently started in China, its laws and regulations, to the extent applicable, do not specifically address certain issues and/or are ambiguous and often incompatible with U.S. grant making practice. To complicate the situation further, the China Securities Regulatory Commission (the "*CSRC*") has indicated that new regulations are forthcoming and has advised certain law firms to counsel their clients against implementing any type of stock plan until final rules are issued.[1] Many companies are unfamiliar with the legal, tax and currency exchange issues associated with granting options in China and may be deterred by the absence of any clear rules for such practice.

Strategy

Before implementing a compensation scheme, a company must evaluate the effectiveness of such scheme in incentivizing and retaining employees. A company should ask "What does my Chinese employee want?" Employees in China attach importance to feeling valued and having a sense of "belonging." As a result, Chinese companies must maintain a reputation for treating their employees well or risk unwanted attrition. In the current business climate, where competition for key employees is fierce, competitive compensation packages determine a company's ability to recruit and retain employees. Options, to the extent they inspire loyalty and commitment and provide employees with a sense of ownership, are a unique and potentially powerful compensation tool.

Against this potential benefit, however, a company should also consider the level of understanding among its Chinese employees with regard to options. An option will not have the intended motivating effect to an employee who does not understand its value. Though educating employees is one resolution to this issue, the cost and logistical burden of such undertaking may outweigh the potential benefit to the company and its employees.

Depending on a company's corporate culture and, possibly, the number of its Chinese employees, a company may choose to focus on key employees, making large awards to senior management, or may make smaller awards to all employees. To both engender loyalty and encourage exceptional performance, a company may decide to take a hybrid approach, granting small awards to all employees and rewarding key employees with larger grants as merit dictates. As a matter of current practice, U.S. companies generally do not make company-wide grants in China and tend to limit grants to senior management and key

[1] *The CSRC has indicated that new regulations are "forthcoming" for some time, and it is yet unclear if the issuance of such regulations is imminent. While a company merely considering making option grants in China would be prudent to wait on such regulations, a company that views such grants as immediately necessary to its recruitment and retention of employees may consider making option grants to key employees only and providing that any such grant by its terms will be revised as necessary to comply with regulations when issued.*

[2] *At present there is no "de minimus" exemption of which we are aware permitting a company to make grants for either a limited number of shares or to a limited number of optionees.*

employees. A number of these key employees have worked in the U.S. and understand the value of options.

Legal Considerations

Popular myth instructs that it is illegal for Chinese employees to hold shares of stock in a foreign company. While this is not true, it actually being the case that shares issued in a "public offering of securities" approved by the CSRC may be held by a Chinese employee, in practice such approval is unlikely to be given and the holding of shares absent such approval may pose a regulatory risk to the company.[2] Companies undeterred by this risk have chosen to avoid having employee hold shares by requiring that options be exercisable only by a cashless "sell-all" exercise method. In a cashless "sell-all" exercise, all of the shares acquired pursuant to the exercise of an option are immediately sold and the employee receives only the cash spread. This works in the case of a public company but not a private company. As discussed further below, the cashless exercise also facilitates compliance with currency exchange controls.

Use of the cashless exercise method is also necessary given current foreign exchange restrictions. At present, Chinese employees may not remit funds in excess of approximately U.S. $10,000 outside of China without the approval from the State Administration of Foreign Exchange nor may they purchase foreign currency for an investment abroad. This exception is unlikely to be helpful for key employees granted options under a public company plan. Although employees could, theoretically, pay the exercise price of an option with funds held outside of China, this is not a realistic alternative since most employees do not keep bank accounts abroad.

The use of phantom stock, where employees are given "credit" for the cash spread on shares they never hold, is another alternative that avoids the issues related to the remittance of funds and the holding of shares, but would likely prove impractical given the lack of familiarity and understanding by Chinese employees. In addition, any grant of phantom stock will be subject to variable accounting, requiring the company to take a quarterly charge as the award vests.

Option grants made in foreign jurisdictions must also comply with U.S. federal and state securities laws and regulations. This obligation is usually satisfied if grants are made pursuant to an equity incentive plan under which grants to U.S. employees are in compliance with U.S. law.

Employment Issues

Regulations under Chinese employment and labor law generally require that an employee's wages be paid in cash. The granting of options, in the event they may be deemed wages paid "in-kind" or in "negotiable instruments", is inconsistent with this requirement but will likely not be deemed a compliance problem by regulatory authorities given the benefit to the employee.

Tax Consequences

An option granted to an employee in China will be treated like a nonqualified stock option under U.S. tax law. The employee will be subject to tax upon exercise under Chinese law. The company's Chinese subsidiary will be obligated to withhold and remit the income tax due upon exercise and to comply with reporting requirements in connection with the exercise of an option. Current law does not provide any means, such as the status of certain options granted to

U.S. employees to be qualified as "incentive stock options, for a company to obtain more favorable tax treatment for its Chinese employees. This is not an issue if a cashless exercise is used when the company is public and there is liquidity in the shares. If the company is private, there would be no liquidity for example if someone leaves the company and must exercise within 30-90 days.

Conclusion

Given the current restrictions and ambiguities of Chinese laws and regulations applicable to option grants in China, as discussed above, a company should take a conservative approach to such practice. Where a company has determined that the use of options is immediately necessary for the recruitment and retention of employees, the options should be granted in a manner that is in compliance, to the extent determinable, with the current laws and regulations. Such a practice may require that options grants are limited to key employees and that such grants, by their terms, will be revised as necessary to comply with rules and regulations as issued. Furthermore, once a company grants options in China, it should closely monitor changes in Chinese laws and regulations applicable to options.

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